exogenous costs. US West summarizes its previous positions, and provides no new support for its position.

THE DIRECT CASE OF GTE

GTE attempts to reargue the existing OPEB Order in much of its Direct Case. GTE ironically maintains any action by an outside body, the FCC, FASB, or any legislative body should be granted exogenous treatment within price caps.[34] GTE fails in this argument, since under its own interpretation, virtually nothing would be endogenous to the price cap formula. Under this scenario, GTE essentially ignores the arguments articulated by the Commission in its OPEB Order, especially when it deals with the proposition that price caps are meant to be an incentive regulation scheme that promotes efficiencies.[35] The greater the proportion of events that are considered exogenous, the lower the incentives within the price cap scheme.

GTE makes efforts to argue that unlike depreciation changes which are endogenous, OPEBs are not solely a decision made by the firm, but rather in conjunction with its unions and work force.[36] While it is true that GTE has taken into account the fact that its work force wanted some level of OPEB, to suggest that GTE has never controlled the amount of OPEBs to be offered, and has no control over the costs associated with the OPEBs is incredibly simplistic. In fact, GTE admits later in its

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[34]GTE Direct Case, p. 6-8.

[35]OPEB Order at 1032.

[36]GTE Direct Case, p. 10-14.

argument that it is addressing OPEB costs, like other costs in a competitive environment.[37] It makes a feeble attempt to reconcile this with its own position by stating that just because it can control costs "does not mean that management control exists in the sense of the exogenous rule."[38] Rather than reconcile its position, GTE illustrates the inherent contradiction in the LEC positions.

GTE does not add additional information regarding the double counting issues. It stands by the Godwins study as the way to remove double counting within the GNP-PI, despite the fact that the Commission has found this study wanting. It dismisses intertemporal double counting as non existent, despite the fact that pay-as-you-go costs are embedded within the price cap formula which increases LEC revenues over time to be in line with long run costs. Without support it dismisses the double count in the rate of return, and the double count in the productivity factor.[39] As such, GTE has added nothing new to the record.

THE DIRECT CASE OF ROCHESTER TELEPHONE CORPORATION

Like the other LECs, Rochester reiterates previously discussed points on the record.[40] In addition, Rochester attempts to dismiss double counting by suggesting that it is either non-existent, or de minimis. Despite the evidence on the record, and the

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[37] GTE Direct Case, p.12.

[38] Id.

[39] GTE Direct Case, p. 19-20.

[40] Rochester Direct Case, pp. 6-8, in its discussion of exogenous costs.

issues raised by the Commission in its discussion of double counting within the OPEB Order, Rochester alleges, without factual documentation, that double counting does not exist.

THE DIRECT CASE OF SOUTHERN NEW ENGLAND TELEPHONE

In its Direct Case, SNET posits that its state approval of implementing SFAS-106 should serve as some precedent for the Commission's approval of SFAS-106 accruals for price cap carriers. SNET, however, does not inform the Commission that its SFAS-106 state approval was allowed in a rate of return regulatory environment. To extend approval of SFAS-106 in a rate of return environment, and translate that to approval in a price cap environment, is faulty logic. To do so would ignore the importance of the risks, rewards, and incentives inherent under the Commission's price cap plan.

ISSUE NUMBER 2. How should price cap LECs reflect amounts from prior year sharing or low-end adjustments in computing their rates of return for the current year's sharing and low-end adjustments to price cap indices?

Introduction

There is no unanimity within the LEC industry as to how sharing and low-end adjustments should be treated when calculating earned rates of return. Some LECs have taken the position in their direct cases that no sharing/low-end adjustments should be made when calculating rates of return, while others have endorsed the Commission's Notice of Proposed Rulemaking ("NPRM") to add-back both sharing and lower formula adjustments. Both positions are wrong and self-serving. Most LECs are simply attempting to avoid their sharing obligations and thereby increase their earnings through the backdoor.

The calculation of earned rates of return for regulatory purposes does not change just because the form of regulation changes, or because of a change in the way prospective rates are set. The methodology for calculating rates of return under rate of return regulation are still valid, today, when calculating rates of return under price cap regulation.

When computing rates of return, sharing amounts must be added-back, and lower-end adjustments must not be added-back. Allowing for sharing add-backs, but not lower-formula adjustments, represents the status quo insofar as rate of return calculations are concerned and does not represent a policy change under price caps. Moreover, there is no legitimate reason for not correctly calculating LEC rates of return right now, as opposed to waiting for the LEC price cap review.

If rates of return are not correctly calculated, customers will not get credit for their entire share of LEC earnings which exceed certain levels under price cap regulation. In addition, the additional revenues customers are required to pay when LEC earnings fall below 10.25 percent will not be included in LEC rate of return calculations.

LEC Direct Cases

In their direct cases, the LECs that oppose both add-back adjustments to base-period earnings calculations claim that such adjustments are improper for the following reasons:

1) price cap orders and/or rules do not expressly require adjustments for sharing/lower formula amounts when calculating base-period earnings;[41]

2) imposition of sharing/lower formula adjustments in the 1993 annual price cap tariff filings would be unlawful retroactive rulemaking;[42]

3) imposition of sharing/lower formula adjustments when calculating rates of return under price caps represents a major policy change which is at odds with price cap regulation;[43]

4) imposition of sharing adjustments (as well as lower-end adjustments) when calculating rates of return overstates actual earnings, double-counts shared earnings, carries the effect of sharing into multiple periods and treats sharing as if it were a refund.[44]

Those LECs that support both add-back adjustments when calculating base-period earnings claim that such adjustments are necessary for the following reasons:

1) price cap regulation would be legally invalid if the Commission did not require the add-backs for both sharing and lower-end adjustments because of the court findings which invalidated the refund rule vis-a-vis AT&T v. FCC;[45]

2) Normalization of earnings via the add-backs is required by existing rules on reporting rates of return;[46]

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[41] See, Ameritech Direct Case at p 5; Bell Atlantic Direct Case at p 6; BellSouth Direct Case at pp 5-6; Pacific Companies Direct Case at p 7; U S West Direct Case at p 8; GTE Companies Direct Case at pp 23-25; and United Direct Case at pp 2-3.

[42] See, Ameritech Direct Case at p 6; Bell Atlantic Direct Case at pp 7-8; BellSouth Direct Case at p 8; Pacific Companies Direct case at p 8; U S West Direct Case at p 9; and

[43] See, Bell Atlantic Direct Case at pp 8-9; Pacific Companies Direct Case at pp 6-7.

[44] See, GTE Companies Direct Case at pp 26-30.

[45] See, NYNEX Direct Case at pp 2-6.

[46] See, NYNEX Direct Case at pp 6-10.

3) unless the add-back for the lower-end adjustment occurs, the relationship between rate of return and productivity growth will be hidden;[47]

4) unless the add-back for the lower-end adjustment occurs, the resulting rate of return calculations are inappropriate for use in applying the Commission's sharing/lower-end adjustment test;[48]

5) unless the add-back for the lower-end adjustment occurs, the rate of return calculations will "double count" the lower-end adjustment impacts, resulting in the lowering of rates twice;[49]

MCI Response

In its comments in the aforementioned NPRM, MCI demonstrated why it was necessary to add back amounts associated with sharing, but not lower formula adjustments. MCI's NPRM comments apply with respect to the claims made by the LECs in this proceeding. MCI will not repeat its NPRM comments, but rather incorporate such comments for purposes of its opposition to the LECs' direct cases by including them as an attachment.

Briefly stated, however, MCI explained in its NPRM comments that sharing amounts under price caps, like refunds under rate of return regulation, must be excluded from the computation of current-period earnings by way of the add-back in order to ascertain whether or not any new refund obligations exist with regard to the current period. The add-back for refunds/sharing amounts associated with earnings in a prior

[47] See, SNET Direct Case at p 6.

[48] See, SNET Direct Case at p 7.

[49] See, SNET Direct Case at p 8.

period allows the Commission to compute the LECs' current period earnings as though no prior-period refund/sharing amount existed.

MCI also explained that all additional revenues derived from rate increases, whether from LFAs under price caps or annual access/mid-year rate filings under rate of return regulation, must be included in the base period that such rates were billed to customers in order to properly calculate rates of return.

MCI specifically explained that the proposed add-back for low end adjustments (aka lower formula adjustments or "LFAs") in LEC rate of return calculations was inappropriate because:

1) The LFA add-back unequivocally and permanently excludes revenues derived from LFA rate increases from ever being included in the calculation of base period earnings;[50]

2) LFA add-backs are inconsistent with earnings monitoring under rate of return regulation;

3) LFA add-backs are inconsistent with the objectives of price cap regulation because they significantly diminish incentives for LECs to improve their performance; and

4) LFA add-backs effectively insulate price cap LECs from earning below a 10.25 percent rate of return under price cap regulation--a guarantee which is tantamount to retroactive ratemaking and not provided for under rate of return regulation.

MCI also explained that in order for the backstop adjustments under price caps to operate in the same way as rate of return enforcement does under rate of return regulation, the Commission must treat sharing amounts like refunds and LFAs like rate

[50] TABLE 1, at page 9 of MCI's NPRM Comments, categorically shows that the lower-formula add-back permanently excludes the additional revenues derived from lower-formula rate increases from ever being included in base-period rate-of-return calculations.

increases. Specifically, the Commission must add-back only sharing amounts but not LFAs when computing rates of return.

With respect to the claims made by those LECs who oppose all adjustments to base-period earnings calculations, MCI believes that such claims are totally without merit. Even though the price cap orders and rules are silent regarding adjustments related to base-period earnings calculations, this should come as no surprise since the way earnings should be calculated for regulatory purposes should not change when the basis for setting prospective rates changes. The only matter that has changed between rate-of-return and price-cap regulation is the basis upon which prospective rates are set and the level (range) of earnings carriers are allowed to earn. The way that regulatory rates of return are calculated should not change.

In fact, the Commission acknowledges, in its NPRM that proposed changes in rate of return monitoring and reporting, that it did not indicate that the add-back provisions in Form 492 (which are used to report earned rates of return) were to be changed. Even though the rules are not explicit on this point, Form 492 and the instructions thereto make it quite clear how the LECs are to calculate their rates of return.

Given that there has been no change in Form 492, it is rather disingenuous for the LECs to claim that the rules do not require any adjustments, and that the imposition of adjustments would constitute unlawful retroactive rulemaking/ratemaking. The status quo with regard to rate of return calculations has not changed.

Moreover, the imposition of the sharing adjustment does not represent a policy change which is inconsistent with price cap regulation. In its NPRM comments, MCI demonstrated why the sharing add-back is necessary to determine whether or not new sharing obligations exist with regard to the current base period. Simply put, failure to make the sharing add-back understates current base-period earnings, and thereby dilutes the earnings and potential for new sharing obligations in the following base period. This occurs because earnings are less that they would have been absent a prior-period sharing obligation. Consequently, when sharing amounts are not added back, new sharing obligations are reduced by reason of the previous base period's sharing obligation. Such an outcome is patently unfair.

MCI also demonstrated that the add-back for lower-end adjustments was inappropriate because it permanently excluded revenues derived from lower-end adjustment rate increases from ever being included in the calculation of base period earnings. MCI also showed that not allowing add-backs for lower-end-related rate increases accomplished the Commission's stated objectives under price caps to ensure that LECs would have an opportunity, not a guarantee, to earn at the lower end of the rate-of-return range in order to preserve the LECs' ability to provide service and attract capital over a prolonged period of time.

AT&T v. FCC

NYNEX claims that price cap regulation will be legally invalidated if the Commission does not require the add-backs for both sharing and lower-end adjustments.[51] NYNEX bases its claim on the AT&T v. FCC court findings which

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[51] See, NYNEX Direct Case at p 2.

invalidated the refund rule. NYNEX specifically claims that if the Commission applied the LFA in a way that would "tend to drive" LEC earnings "below" the LFA level (10.25 percent), the Commission would contradict its own rate of return findings in the same way that it did in AT&T v. FCC.[52] NYNEX also claims that such action by the Commission would be confiscatory.[53] NYNEX is mistaken; moreover, the court case has no bearing on the issues currently before this Commission.

NYNEX suggests that the court found that regulated carriers are guaranteed a minimum rate of return, and that the aforementioned court decision somehow addressed the particulars of how to calculate earned rates of return for regulatory purposes. This is not correct.

The aforementioned court case invalidated the refund rule and nothing else. The refund rule was invalidated because it required carriers to refund earnings above an allowed level, while not allowing carriers to recoup any earnings below said level. The court found that the refund rule produced a systematic bias which, over time, would depress carrier earnings below the allowed rate of return.[54] That is all the court found.

The court did not invalidate the Commission's methodology for calculating carrier rates of return. The calculation of rates of return was taken as a given and was not at issue. Indeed, the court made no findings whatsoever regarding the Commission's

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[52] Id., at p 4.

[53] Id., at p 5.

[54] American Tel. and Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988)

methodology for calculating rates of return, nor did it invalidate Form 492 or any of the instructions thereto.

Even though the court affirmed the long standing view that regulated carriers are not guaranteed a rate of return, NYNEX argues that the LFA add-back is necessary so that LEC earnings are not driven below the LFA level (10.25 percent). NYNEX even has the audacity to claim that the LFA is like "backbilling" because LECs receive LFA revenues to compensate them for underearnings in a prior period.[55] This is outrageous.

First, backbilling is not like a prospective LFA rate increase. Backbilling amounts to nothing more than billing someone for services which were rendered (and earned) and should have been billed in a prior period. The LFA-related rate increases are nothing like backbilling, and the Commission has made it perfectly clear that the LFA provides carriers prospective rate relief.

Second, NYNEX would have the Commission believe that a LFA-related rate increases in any given year are expressly intended to recover the costs of providing service which were incurred in a prior year. This is nonsense. Moreover, such a view effectively guarantees carriers a minimum return of 10.25 percent. This is tantamount to retroactive ratemaking. The Court even noted the following with regard to LEC earnings:

> The Commission itself acknowledged that the refund rule introduces a "systematic bias" that operates to depress carrier earnings below their target "over the long run."... Indeed, since the Commission views the rate of return as a minimum, the refund rule under the Commission's view would operate over the long run to put a carrier out of business. It should be stressed that this result does not reflect

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[55] See, NYNEX Direct case at p 7.

> merely the business risk that a carrier is bound to accept under the accepted view that regulation does not guarantee the regulated company a profit.[56] (Emphasis added)

The Court clearly did not state or in any way imply that regulated carriers are guaranteed a minimum rate of return. Moreover, it did not state how carrier rates of return are to be calculated.

The Commission also espoused this same tenet with respect to price cap regulation. The Commission unequivocally rejected the concept of a guaranteed, minimum rate of return when it stated the following:

> A guarantee of earnings at the full level of the prescribed rate of return eliminates genuine risk and is thus overly favorable to LECs and inimical to this [incentive regulation] approach. LECs request that the plan accord them an assurance that their earnings will not slip below the prescribed rate of return, forgetting that this earnings level is a target, not a certainty, even under rate of return regulation. The plan gives LECs flexibility and the right to retain more of their earnings; it balances these opportunities against the possibility that LECs might earn less if they fail to respond to the incentives provided. LECs are reasonably expected to become more efficient in order to earn higher profits, or even to maintain their current profits....If the formula applies harmfully to any particular LEC, the lower adjustment mechanism offers a remedy, while still providing an incentive to become more profitable by increasing efficiency, not rates.[57]

LEC rates of return are clearly not guaranteed.

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[56] American Tel. and Tel. Co. v. FCC, 836 F.2d 1386 (D.C. Cir. 1988)

[57] See, In the Matter of Policy and Rules Concerning Rates for Dominant Carriers, Order on Reconsideration, Released April 17, 1991, para 117.

ISSUE NUMBER 3. Does U S West's filing, claiming a change in a DEM allocator as exogenous, comply with Section 61.45(d)?

Introduction

The answer to this question is "no."

In its Reply to petitions in the 1993 annual access filings, U S West explained "how" its DEM allocator and DEM exogenous cost adjustment were developed. What U S West has not yet explained is "why" its 1993 DEM adjustment is uncharacteristically low when compared to quantitative expectations. U S West's direct case in this year's annual access filing investigation doesn't explain why its 1993 DEM adjustment is uncharacteristically low either. U S West's direct case regarding its DEM adjustment boils down to this:

1) U S West believes that it has complied with Commission's separations rules with respect to the calculation of its exogenous cost adjustment for the DEM separations change;[58]

2) U S West notes that the Commission has not found its DEM methodology unreasonable in the past;[59] and

3) U S West purports to show that it has lowered interstate rates over the past several years by an amount which is greater than the shift in DEM-related costs from the interstate to the state jurisdictions.[60]

MCI Response

With respect to these matters raised in U S West's direct case, MCI would note that U S West has not offered any meaningful explanation, data and/or other information

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[58] See, U S West Direct Case at p 9.

[59] Id., at p 10.

[60] Id., at pp 10-11 and Attachment 3--Exhibit 1.

as to why U S West's 1993 DEM adjustment falls well below quantitative separations-based expectations. Nor has it explained why its DEM adjustment is so far below that of other LECs. And just because the Commission has not found fault with U S West's DEM methodology in the past does not begin to explain why U S West's 1993 DEM adjustment is uncharacteristically low this year.

MCI will not repeat its earlier explanations as to why U S West's DEM adjustment is understated by some $5.5 million.[61] MCI continues to believe that U S West's DEM adjustment is wrong and U S West has said nothing in its direct case which challenges that belief.

In Attachment 3 to its direct case, U S West purports to show that it has lowered interstate rates over the past several years by an amount which is greater than the shift (change) in DEM-related costs from the interstate to the state jurisdictions. According to U S West, it has reduced rates by $5.6 million <u>more</u> than the change in its DEM revenue requirement over the past several years.[62]

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[61] In its petition in the 1993 annual access filing, MCI demonstrated that (given the formulae in 47 CFR 36.125 regarding the phase out of the weighted DEM) the calculated change in the exogenous DEM adjustment from last year's filings should be using a hypothetical composite DEM allocator and unweighted (or measured) DEM. Based upon hypothetical DEMs and Commission rules, MCI calculated that the DEM adjustments filed by the price cap carriers in this year's access filings should be approximately <u>sixty-six percent lower</u> than the DEM adjustments filed in last year's filings.

MCI then compared the expected change in the DEM adjustments with the 1993 DEM adjustments filed by the price cap carriers. The results revealed that the DEM adjustments for most price cap carriers were very close to the MCI calculated expectations, with the exception of US West DEM adjustment. DEM adjustments for the majority of the price cap carriers from last year's access filing to the current filings was within a very narrow range, i.e., between 60 and 70 percent. Moreover, the average for these companies, excluding US West, equaled the MCI expected decrease of 66 percent. However, the U S West DEM adjustment decreased by a whopping 95 percent.

[62] <u>See</u>, U S West Direct Case at p 11 and Attachment 3--Exhibit 1.

MCI believes that Attachment 3, specifically Exhibit 1, supports its belief that U S West has indeed understated its 1993 DEM adjustment. Table 1 below compares the revenue requirement change per the annual filings with the actual revenue requirement change derived by U S West by year. The amounts were taken from U S West Attachment 3--Exhibit 1. Except for 1990 and 1993, the ratio of revenue requirement changes per the annual access filings to the actual revenue requirement changes -- by year -- falls within a range of 87 percent to 99 percent. However, the proposed 1993 DEM adjustment of ($753,000) represents only 18 percent of the actual revenue requirement change that U S West now expects. U S West's very own calculations show that its proposed DEM adjustment is understated by at least $3.448 million (-$753,000 1993 Exogenous DEM Adjustment less -$4,201,000 Derived DEM-related revenue requirement change).

TABLE 1

($000)	Annual Filing Rev Req Change (a)	Actual Interstate Rev Req Change (b)	% (c)=(a)/(b)
1988	$(9,954)	$(10,947)	91%
1989	(23,449)	(24,027)	98%
1990	(33,818)	(20,539)	1.65%
1991	(19,505)	(19,723)	99%
1992	(16,782)	(19,208)	87%
1993	**(753)**	**(4,201)**	**18%**

It is also worth noting from Table 1 that U S West has understated its exogenous DEM cost adjustment in each and every year since 1987 save one.

Given that Footnote 2 in Attachment 3--Exhibit 1 states that the estimated revenue requirement for 1993 of $(4,201,000) is based upon only five months of actual data and "may appear unusually small," MCI continues to believe that U S West has understated its DEM adjustment by at least $5.5 million, even though its calculations clearly show that its 1993 DEM adjustment is understated by some $3.4 million.

CONCLUSIONS

For the reasons discussed above, MCI urges the Commission to reject exogenous treatment of SFAS-106 accruals as filed by the LECs in their 1993 Annual Access Tariff Filings. MCI has also demonstrated that sharing amounts should be added back, and low end adjustments should not be added back, when calculating rates of return. Such a process would mimic the status quo for determining rates of return. Finally, MCI has demonstrated that U S West's direct case has not shown that it has not understated its 1993 DEM exogenous access charge reduction by $5.5 million.

Respectfully submitted,

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Dated: August 24, 1993

STATEMENT OF VERIFICATION

I have read the foregoing, and to the best of my knowledge, information, and belief there is good ground to support it, and that it is not interposed for delay. I verify under penalty of perjury that the foregoing is true and correct. Executed on August 24, 1993.

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<u>CERTIFICATE OF SERVICE</u>

I, Carolyn McTaw, do hereby certify that copies of the foregoing MCI petition were sent via first class mail, postage paid, to the following on this 24th day of August, 1993:

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